

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Fourth Quarter of 1999 to the Fourth Quarter of 2003

The U.S. economy officially entered uncharted waters in February 2000. That is when the current economic expansion became the longest on record by entering its 107th month of non-stop growth. The previous record was during the Vietnam War-era, a 106-month expansion from February 1961 through December 1969. Despite being ancient by historical standards, the current expansion shows no signs of ending. This is because expansions do not simply die of old age. They end due to unforeseen pressures or policy mistakes. The U.S. economy appears fundamentally sound, with none of the telltale signs that traditionally occur toward the end of an expansion, such as rising inflation. While tempting, it is too early to declare the business cycle dead. Instead, fundamentals point to the business cycle continuing its current favorable phase. The short-term outlook for the U.S. economy is bullish. Although the rate of growth is expected to cool, the current expansion should continue through 2003.

It is useful to compare the current expansion to the 1960s expansion to see if the latter offers any clues as to when the former will run out of steam. When it occurred, the 1960's expansion was unique. It was by far the longest expansion in U.S. history; only the World War II expansion of 80 months came even close. Growth was also much stronger than average. Real GDP rose 4.8% per year during the 1960s boom, compared to 3.2% per year so far in the 1990s. Average growth during the current expansion is more in line with the averages of the previous two long expansions. Thus, the strength of the 1990s expansion is no surprise—only its length. Another major difference is inflation, and this is an important indicator to watch. In 1966, the rate of inflation began to climb. In the last two years of that expansion, unemployment fell below 4.0% (full employment) and inflation escalated to 5.6%. In contrast, there is little evidence of inflation even in the ninth year of the 1990s expansion.

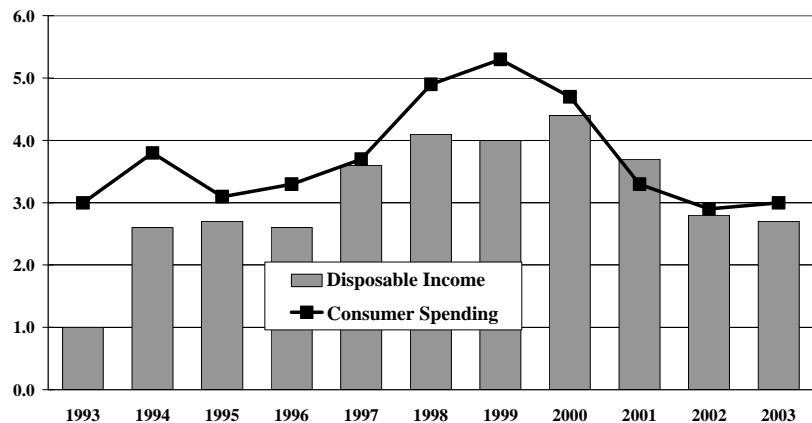
The 1960s expansion ended in 1970 when the Federal Reserve tightened to fight rising inflation and military spending plunged when the Vietnam War subsided. The dramatic cutback in military spending could have been offset by lower interest rates, except for the higher inflation. But in 1969 it did not appear to be prudent to chop interest rates while inflation was running above 5% and the unemployment rate stood below 4.0%. Instead, from mid-1967 through the end of 1969, the Federal Reserve raised the federal funds rate five percentage points to 9.0%. In the current expansion, low inflation is giving the nation's central bank more room to maneuver than in the 1960s expansion. The Federal Reserve is taking advantage of this increased wiggle room to tighten gradually so it can avoid making drastic (and devastating) increases in the future. The federal funds rate is up 2.75 percentage points from the expansion low of 3%.

Chairman Greenspan and company's recent actions do not mark the beginning of the end for the current expansion. For example, the Federal Reserve raised interest rates in the mid-1990s and engineered a "soft landing" that slowed the economy without plunging it into a recession. With inflation low and the economy sound, the central bank has even more leeway to pull off another "soft landing" should the need arise. Also, past expansions appear to have required at least two years of rising inflation to cause the Federal Reserve to overreact. Even if the fourth quarter 1999 data did indeed represent the start of such an inflationary cycle, the economy would probably still have clear running until late 2001.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: Consumer confidence remains high despite surging gasoline prices, higher interest rates, and the jittery stock market. American consumers, while vocal about gasoline price increases, have not yet significantly curbed their expenditures. So far, it appears that Americans consider these increases to be temporary. Higher interest rates appear to be taking the steam out of the housing market, but other traditionally interest-rate sensitive parts of the economy are yet to be affected. Most notably, light-vehicle sales jumped to 19.2 million annual units in February

Real Spending & Real Income Growth

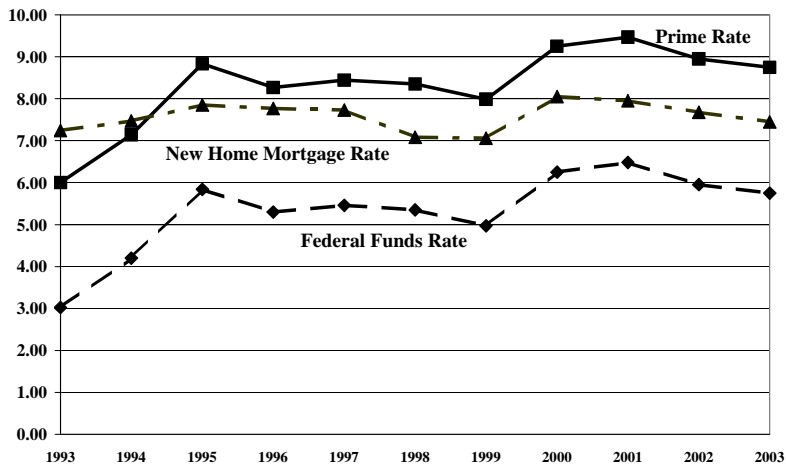


Source: Standard and Poor's DRI

2000—its strongest showing since 1986. Part of the reason that consumer confidence and spending has remained strong is the so-called “wealth effect,” which has resulted in increased dependence on the performance of the stock market. A recent study by the Federal Reserve shows that Americans are clearly richer since 1995. Median inflation-adjusted net worth climbed from \$60,900 in 1995 to \$71,600 in 1998. The primary reason for the gain was the soaring stock market. The share of households owning stock has risen from just over 30% in 1989 to nearly 50% in 1998. Not surprisingly, the booming stock market has raised financial assets as a share of total household assets. In 1989, financial assets accounted for 30.4% of household assets, compared to 40.6% today. Within the financial assets there has been a sharp increase in ownership of stocks, mutual funds, and retirement accounts. Together these three categories accounted for 62.7% of all household financial assets in 1998, compared to just 41.8% in 1989. Offsetting this has been the decline in bank accounts. Transaction accounts and certificates of deposit have dropped from 29.3% of assets in 1989 to 15.7% today. Real spending could slow or drop should the stock market suffer a sustained correction. It appears that such a correction seems unlikely in the near future. Instead, stock market gains are more likely to slow from their recent double-digit pace, and this will have a slight dampening effect on consumer confidence and spending growth. In addition, it is assumed that consumers will be less willing to tap into savings or take on more debt to fund spending in the future. As a result, for the first time since 1992, real consumer spending should grow slower than real disposable income in 2001. Real disposable income is expected to rise 4.4% in 2000, 3.7% in 2001, 2.8% in 2002, and 2.7% in 2003. Real consumer spending should advance 4.7% in 2000, 3.3% in 2001, 2.9% in 2002, and 3.0% in 2003.

Financial: There were several reasons to think that the Federal Reserve had completed its most recent round of tightening last fall. First, interest rates in the U.S. were above those in other industrial countries. Second, although nominal interest rates were low, real interest rates were relatively high because of low inflation. Third, the nation’s central bank traditionally does not like to undertake major monetary policy moves in a presidential election year. The end of tightening seemed to be confirmed when the Federal Reserve passed on its opportunity to increase rates again at its December 21, 1999 meeting. But this has proven to be just a pause in the current tightening cycle. Once concerns over the Y2K transition had passed, the Federal Reserve once again raised interest rates. It increased the federal funds rate by 25 basis points at both its February 2, 2000 and March 21, 2000 meeting, so that this bellwether rate stood at 6.0% in the spring of 2000. On several occasions, the Federal Reserve has

Selected Interest Rates

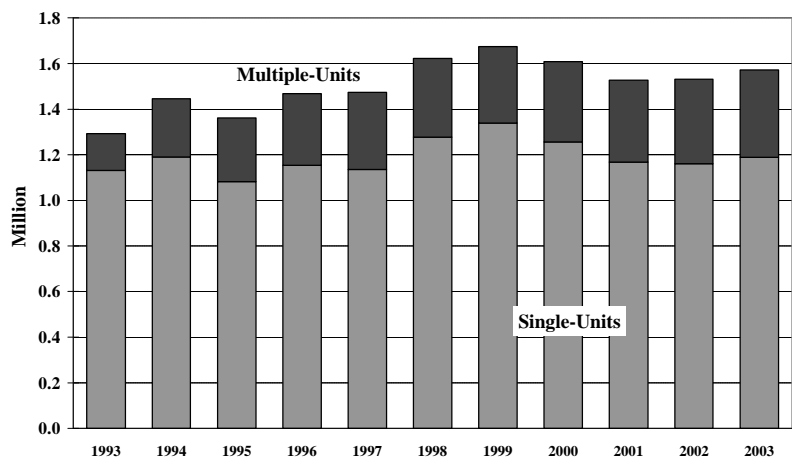


Source: Standard and Poor's DRI

warned that inflation pressures may be building because aggregate demand may be running faster than potential supply. This indeed seems to be the case. While overall inflation has not yet flared, real GDP has advanced at an astonishing 7.3% annual pace in the last quarter 1999. This strong growth gives the Federal Reserve reason to tighten further, and they can be expected to do so. The current forecast assumes two more 25-basis point rate hikes, so the federal funds rate should be at 6.5% this summer. Mortgage rates are expected to peak in the first half of this year, then gradually ease.

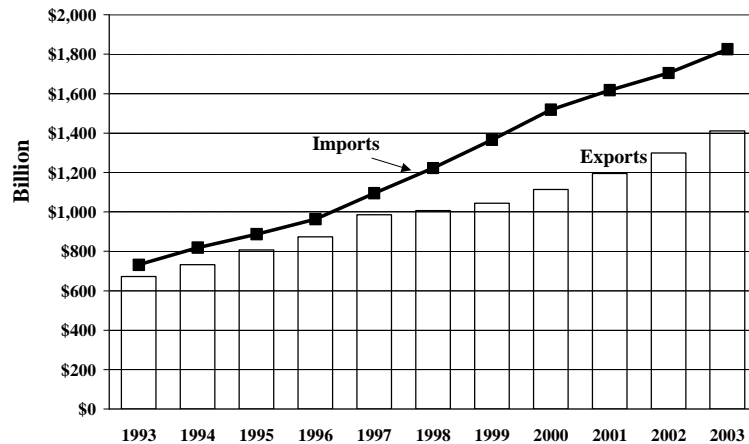
Housing: The high-flying U.S. housing market may finally be feeling the drag of higher mortgage interest rates. From the beginning to the end of 1999, the effective mortgage rate for existing home sales rose by about 70 basis points. Despite rising rates all year, home sales were not noticeably impacted all of last year. Home sales were buoyed by so-called “fence sitters” who jumped to buy homes when interest rates first began to rise. In addition, homebuyers turned to adjustable rate mortgages when fixed-rate mortgages began to climb. High levels of consumer confidence and strong income growth also helped home sales remain strong. However, recent declines have been significant. For example, sales of existing homes dropped 10.7% in January 2000, to an annual rate of 4.59 million units—its largest drop in almost five years. New home sales were similarly affected in January, falling 4.2% to a seasonally-adjusted annual rate of 882,000 units. It is less clear whether rising rates have had as much of an impact on U.S. housing starts. On one hand, builders are still reporting rising backorders for new homes. On the other hand, they are expressing increasing pessimism about the market’s outlook over the next several months. Along with the stock market, the value of housing has enjoyed healthy increases recently. Over the last four years the average selling price for an existing home has climbed 26%. This has created an enormous increase in housing wealth. While less than the wealth gains from the stock market, it has been more widespread. This is because two-thirds of Americans own their homes, while only about half hold stocks. Chairman Greenspan estimates that over the last four years, this run-up in housing values has added \$55 billion to consumer spending. Unfortunately, anticipated higher interest rates should reduce housing appreciation to about 3.5% per year. The higher interest rates will also contribute to lower new and existing home sales over the forecast period. Nationally, housing starts are expected to drop to 1.61 million units this year, 1.53 million units next year, 1.53 million units in 2002, and 1.57 million units in 2003.

U.S. Housing Starts



Source: Standard and Poor's DRI

Real U.S. Imports and Exports



Source: Standard & Poor's DRI

International: Real exports and imports should grow more in line with each other over the next few years, as the economies of U.S. trading partners (except for Japan) begin to heat up. China will remain the fastest growing economy, averaging about 7% growth over the forecast period. Middle-income Asia (Indonesia, South Korea, Malaysia, Philippines, Taiwan, and Thailand) should continue its recovery, advancing about 5.0% per year. South Korea is the bellwether for the rest of Southeast Asia. Its economy is presently operating above pre-crises levels. This quick

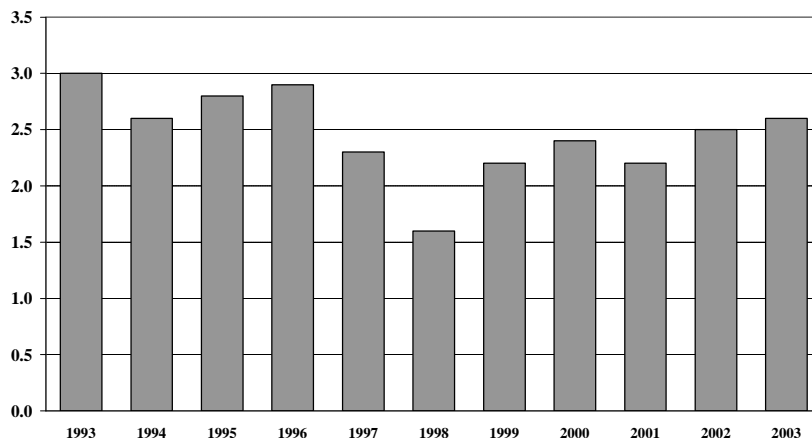
turnaround is in no small part due to the rising electronics cycle. Likewise, Mexico's output is also forecast to rise about 5% annually. South America (Argentina, Brazil, Chile, Columbia, Ecuador, Peru, and Venezuela) is expected to recover from its 1.4% downturn in 1999. Aiding this recovery is the strong U.S. economy, muted inflation, lower interest rates, stronger public finances, and rebounding commodity prices. This region's economic growth should rebound 2.8% in 2000, then average just below 5% from 2001 to 2003. America's largest trade partner, Canada, is projected to grow by around 3.0% per year, which, while still strong, is down from its 3.7% showing in 1999. The Western Europe (France, Germany, Italy, and the United Kingdom) economy is anticipated to improve, rising just under 3.0% annually. France is expected to be the strongest performing economy in this group, thanks to both strong domestic demand and exports. The latter reflects stronger world demand and the bargain-priced euro. Japan, while showing some signs of improvement, is expected to remain the caboose of world economic growth. Japan's economy declined 2.5% in 1998 and grew by an anemic 0.3% in 1999. Over the next few years it is forecast to grow by about 1.0% per year. While this is stronger than in its recent past, it is much lower than the 3.1% anticipated for the U.S. It should also be noted that the loss of Prime Minister Obuchi this spring raises uncertainties about the future direction of Japan's economy. While the real trade gap is expected to continue to widen over most of the forecast period, this gap will grow more slowly than in the recent past due to rebounding exports. Real U.S. exports grew just 3.6% in 1999, but they are projected to rise 6.7% in 2000, 7.3% in 2001, 8.7% in 2002, and 8.6% in 2003. Real imports are expected to grow 11.1% in 2000, 6.6% in 2001, 5.3% in 2002, and 7.1% in 2003. The U.S. real trade deficit is anticipated to be \$404.4 billion this year, \$423.2 billion next year, \$405.3 billion in 2002, and \$414.3 billion in 2003.

Inflation: There are few signs that inflation pressures are building, despite runaway oil prices, surging tobacco prices, and the tightest job market in a generation. Over the past year, the price of crude oil has nearly tripled. As a result, after sliding for a year and a half, the energy component of consumer prices reversed course and soared by double-digit rates beginning in the second quarter of 1999. It has had less of an impact on overall consumer prices. However, the impact of higher oil prices will eventually be felt because of the widespread use of petroleum products in the manufacturing and transportation sectors. Late in the summer of 1999, Philip Morris announced an 18-cents per cigarette pack increase in order to cover the rise in federal excise taxes and to fund its legal obligations. Even with these changes, overall inflation accelerated from 1.6% to just 2.6%. Interestingly, when energy and food are excluded from the index, inflation actually slowed to less than 2.0%. This flies in the face of conventional wisdom. The core inflation rate (overall less food and energy) is driven primarily by employment costs. Given that the U.S. civilian unemployment rate has been flirting with sub-4.0%

levels recently, it would be appropriate to assume that employment costs should be rising. However, employer costs increases have remained unusually tame. This may be the result of the changing structure of the labor force and methods of compensation. Tight labor markets have forced employers to accept lower skilled workers and offset the lack of skills with training and computerization. For the workers involved, this can mean better pay than they might have aspired to in the past. Second, the jury is still out on what impact

the use of stock options in the high-tech sector will have on true labor costs. Another factor keeping employment costs down is rising productivity. As long as labor costs grow slower than productivity, they will not put pressure on inflation. The U.S. Bureau of Labor Statistics reported that productivity advanced 6.0% in the fourth quarter of 1999—its strongest quarterly gain in seven years. Unfortunately, the numbers on which the productivity measures are based are suspect. If they understate the number of hours worked, then the productivity number is overstated. Consumer prices are expected to accelerate slightly over the next few years. Specifically, consumer inflation is forecast to be 2.2% in 1999, 2.4% in 2000, 2.2% in 2001, 2.5% in 2002, and 2.6% in 2003.

Consumer Price Inflation

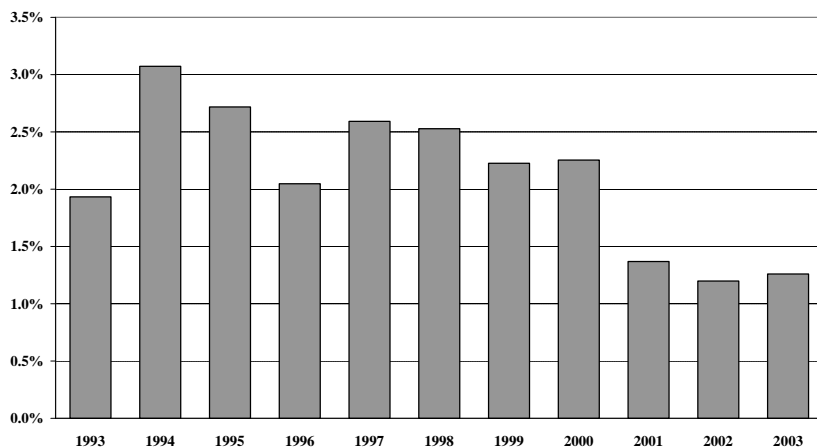


Source: Standard and Poor's DRI

Employment: The U.S. labor market remained tight in the first quarter of this year, with the civilian unemployment rate holding near 4.0% in each month. Another measure of the job market's health, nonfarm employment, also showed strength, but its performance was not as consistent as the unemployment rate. Specifically, nonfarm employment rose by 384,000 in January 2000. This was followed by a gain of just 43,000 jobs in February 2000. In March 2000, nonfarm employment expanded an eye-popping 416,000 jobs, which was well above the prior six-month average gain of 226,000 positions. March's job gain, like those of January and February, appear to be anomalies. For example the average gain for January and February is 213,500, which is not far from the previous six-month average. The March payroll increase is distorted by hiring for the U.S. Census, an unusual five-week reporting period, and the return of striking workers at Boeing. Census hiring added 117,000 to the March job gain, while the end of the Boeing strike added an additional 15,000. While it is impossible to

predict with certainty the effect of the five-week reporting period, a 75,000 jobs increase seems like a reasonable estimate. When all the impact of these anomalies are accounted for, the March payroll gain is about 209,000, which is near the prior six-month average. While it appears the labor market is not likely to tighten further, neither is it expected to loosen significantly. The U.S. civilian unemployment rate is forecast to go from 3.9% in 2000 to 4.3% in 2003, which is still well below the 5.5% rate that is consistent with full employment.

U.S. Nonfarm Employment Growth



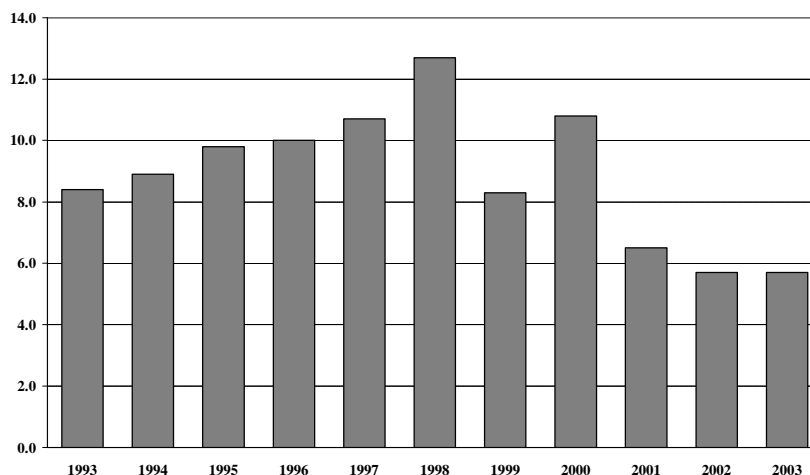
Source: Standard and Poor's DRI

Over the forecast period, nonfarm employment is expected to slow after this year. One of the reasons for the slowing is a dwindling labor supply.

Business Investment: Real business investment will slow after the year 2000. This is an important change because real business spending has been one of the economy's most consistent performers during the current expansion. For example, this measure has grown much faster than the overall economy in every year since 1992. A major portion of this growth was fueled by the huge investment in computer technology. This surge reflected economic necessity. Finding themselves competing in an increasingly crowded global market, American businesses

invested heavily in order to remain competitive. In addition, the tightening labor market created the need to replace labor with capital, a move that was facilitated by attractive interest rates. This expansion of the nation's capital base helps to explain the recent surge in U.S. productivity. Between 1974 and 1995, nonfarm business productivity averaged only 1.5% growth. Since 1996, though, it has averaged 2.6% growth. In the fourth quarter of 1999, it rose an impressive 6.0%. After this year, rising interest rates and the slowing economy will begin to take their toll on business investment. Real business investment is projected to advance 10.8% this year, 6.5% next year, 5.7% in 2002, and 5.7% in 2003.

Real Business Investment Growth



Source: Standard and Poor's DRI